COUNCIL on
FOREIGN
RELATIONS

July 29, 2015

Greece's Euro Future and U.S. Policy: A Narrow Path Forward

Prepared statement by

Robert B. Kahn

Steven A. Tananbaum Senior Fellow for International Economics
Council on Foreign relations

Before the

Committee on Foreign Relations

SUBCOMMITTEE ON EUROPE AND REGIONAL SECURITY COOPERATION
United States Senate
1st Session, 114th Congress

Hearing on the Financial Crisis in Greece—Implications and Lessons Learned

Chairman Johnson, Ranking Member Shaheen and other members of the Foreign Relations Subcommittee on Europe and Regional Security Cooperation, it is an honor to testify on the Greek financial crisis. The agreement earlier this month between Greece and its official creditors has prevented, for now, a disruptive Greece exit from European monetary union. With adequate support from major creditors, this deal offers a narrow path for Greece to return to sustainable growth with the euro. But difficult choices face the Greek government and people in the days ahead, and Grexit remains a very real possibility, perhaps even the most likely outcome.

Greece's direct trade and financial links to the U.S. economy are small, and there is less of a direct systemic threat to the United States than it was when the crisis began in 2009. But the risks are still material, and what happens in coming days and months can have dramatic consequences for Europe and for the global economy. While our leverage on intra-European negotiations is limited, there are a number of channels through which we can influence the path of the crisis, and it remains of vital importance to the United States that we remain involved—through the International Monetary Fund (IMF), the Group of Seven (G-7) and bilaterally with European governments.

The Council on Foreign Relations takes no institutional positions on policy issues and has no affiliation with the U.S. government. All statements of fact and expressions of opinion contained herein are the sole responsibility of the author.

In my testimony today, I want to examine the Greek crisis—how we got here, where we are going, and the critical decision points in coming months on which the United States can and should strive to influence outcomes.

Economic Decline, Fiscal Consolidation and Debt Reduction

Since the start of the Greek debt crisis in October 2009, the country has experienced one of the most severe economic depressions for an economy not at war in the modern era (Figure 1). The size of the Greek GDP has shrunk by 25 percent since 2009, the unemployment rate has soared to over 25 percent, and youth unemployment is near 50 percent. After a return to modest growth in 2014, the economy fell back into recession as a result of the Syriza-led government's brinkmanship with its creditors, which resulted in a fiscal crisis, a bank run, and the subsequent closure of the banks.

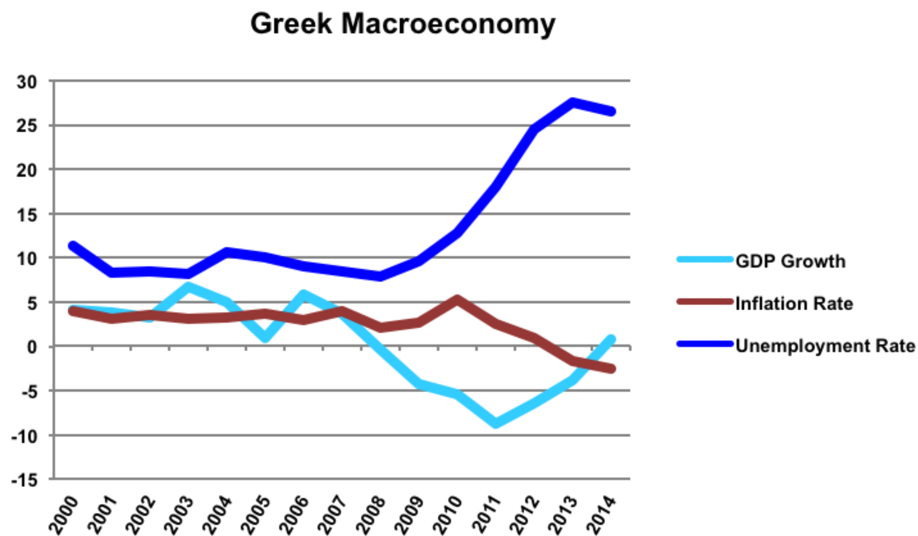


Figure 1
Source: IMF World Economic Outlook

There have been a number of excellent autopsies of the Greek experience, and I do not attempt to do service to the painful history of the period here. But a few observations are helpful to put the current debate in context. Certainly there is plenty of blame to go around for this disastrous economic performance: weak Greek policies, excessive deficits, and a distorted economy meant that Greece was always going to struggle to remain competitive within European monetary union. From this perspective, the economic problems of Greece date from well before 2009. Repeated adjustment programs prioritized fiscal adjustment over tough but necessary structural reforms to labor and product markets that would have allowed a return to growth, as we are now seeing elsewhere in the periphery. In addition, the incomplete nature of economic union in Europe–lagging well behind political union—also contributed to the current crisis. In particular the lack of fiscal union meant that Europe did not have the automatic fiscal transfers that we take for granted in the United States. Further, the inability to deal in a comprehensive fashion with the debt problems of the periphery further constrained Greece's room for maneuver and, in conjunction with weak overall growth in the euro area, limited demand for Greek goods.

Still, the proximate cause for the severe depth of the Greek recession was the drag from fiscal austerity. At the start of the crisis, the Greek primary fiscal deficit was on the order of 10 percent of GDP (with an overall deficit of nearly 16 percent). Even with significant financing, the shift from a deficit of that size to a small

primary surplus last year represented a massive contraction in demand. From one perspective, it is unfair to blame creditors for austerity: after all, while a portion of the financing went to meet maturing debt, external financing also allowed for a much more gradual path of fiscal adjustment than would have been the case otherwise, and deficits that remained for most of the period were among the largest in the eurozone. But the IMF has admitted that it underestimated the amount of drag (the fiscal multiplier) that would result from this level of fiscal consolidation at a time of low growth and significant economic slack across Europe. From this perspective, the surplus countries of Europe could have done much more to stimulate demand while the periphery countries adjusted.

Before the crisis, the debt looked sustainable on the basis of ready market access at low interest rates. (Figure 2). With the onset of the crisis, borrowing costs soared (figure 3), contributing to a “doom loop” in which high government debt undermined confidence and prospects for the banks, which in turn worsened perceptions of creditworthiness for the government to clearly unsustainable levels (Figure 3).

10-Year Bond Yields of Greece

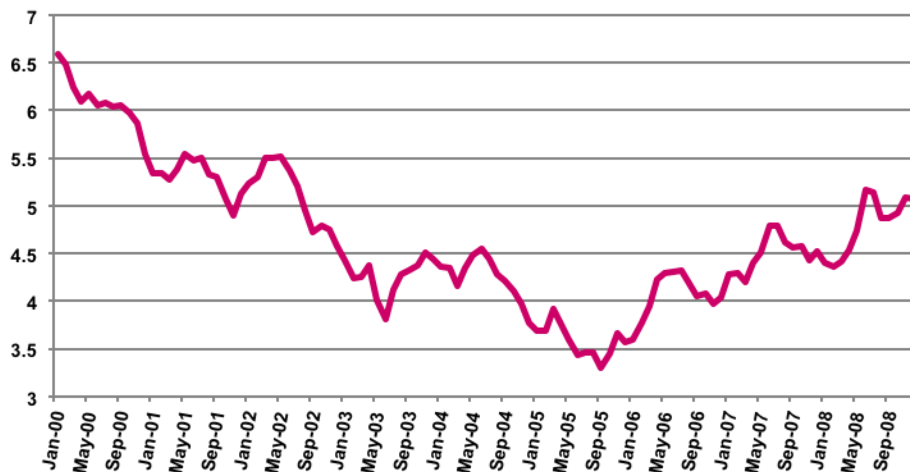


Figure 2
Source: European Central Bank (ECB)

10-Year Bond Yields and Spread

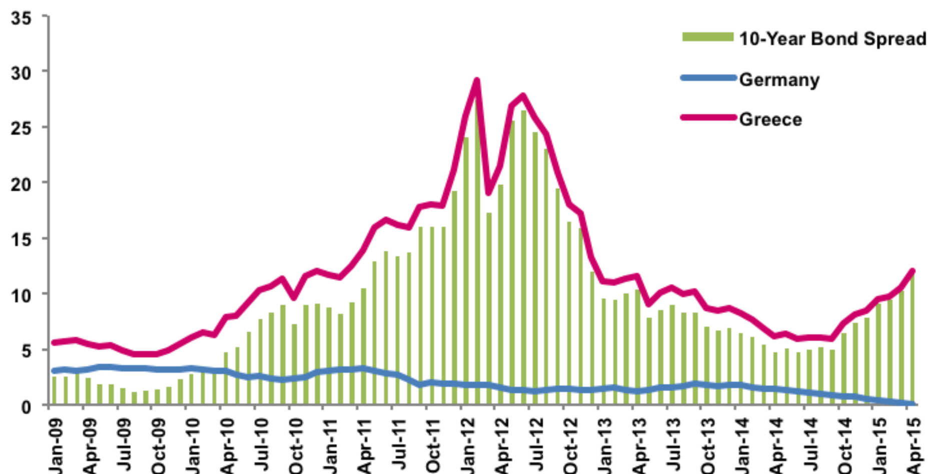


Figure 3
Source: European Central Bank (ECB)

By April 2010, the bond spreads rose to such a level that Greece essentially lost market access to finance its government. Greece subsequently requested financial assistance from the European Union (EU) and IMF, the first of a series of rescue packages that cumulatively have provided roughly $250 billion in funding. IMF lending during this period was well in excess of the normal quota-based lending limits, which under the existing exceptional access rules would have required a finding that the debt was sustainable with "high probability." In the absence of that finding, the Board decided to create a new "systemic exemption" that allowed this requirement to be suspended when there was "a high risk of international systemic spillovers." This rule—which has also been used in programs for Portugal and Ireland—has become the center of a current debate over the appropriate flexibility in an uncertain world where political factors can come into play in deciding on IMF lending.

While there were important success in the IMF programs, and a number of reviews completed, there were also some "notable failures," as IMF admits in an ex post evaluation[1]. The program did not restore investor confidence or help Greece regain market access. The debt did not become sustainable and had to be restructured in 2012. Their report highlighted overly optimistic macroeconomic assumptions, as well as an overestimation of the Greek government's ability to implement policy reform.

Following elections in January 2015, the new government abandoned its existing program, and sought to open new negotiations with a goal of ending austerity and achieving comprehensive debt reduction, all while remaining in the eurozone in good standing. These promises, coupled with their decision to roll back a number of reforms put in place by the prior governments, put Greece on an immediate collision course with its creditors. Despite improving regional headwinds (including improved growth and low interest rates), there was a significant worsening of economic conditions, with the economy returning to recession and the primary fiscal positon turning negative. A deposit run from the banks was offset initially by extensive support from the ECB, but when the government decided to pull out of negotiations in late June, the ECB froze that support, leading to the closure of the banks.

The July 2015 Agreement

On July 22nd, the Greek legislature passed the second round of reforms, focused on: the court system backlog; protecting small depositors; and the introduction of rules to allow bank shareholders and creditors to cover the costs of failed banks.[2] These votes move Greece and its international creditors into the formal negotiating phase.

European leaders, meeting late into the night of July 12 in Brussels, reached an agreement that offers a path for Greece to remain within the eurozone. But it is an extraordinarily difficult path, requiring a commitment to market-oriented reform that this government—as well as previous ones—has not been able to sustain. The agreement traced out a series of steps which, if fully implemented, would lead to Greece receiving financing over the next three years totaling at least €86 billion. The first steps along this path have now been completed. In two rounds of legislation, the Greek government passed measures including substantial value-added tax (VAT), other taxation, and pension reforms; a new code of civil procedure as

[1] IMF (2013) "Greece: Ex Post Evaluation of Exceptional Access under the 2010 Stand-By Arrangement"
[2] http://www.bbc.com/news/world-europe-33616177

part of judicial overhaul; full implementation of past EU laws, including procedures for automatic fiscal cuts when targets are not met; and, implementation of bank recovery and resolution directive as first step towards fixing the banks. In return, European creditors provided bridge financing totaling €7 billion on July 17 that allowed Greece to make debt payments and repay arrears to the IMF. The European Commission (EC) also unveiled plans to release €20 billion from the European Structural and Investment Funds, and €15 billion from the EU Agricultural Funds to support the Greek recovery over a number of years.[3]

Negotiations have begun this week on a broader agreement with the European Stability Mechanism (ESM) rumored to be in the range of €30-40 billion. These negotiations would address some of the most sensitive areas including early retirement and raising tax rates on farmers. Further reforms including: (i) Eliminating the pension deficit (that now stands at 10 percent of GDP); (ii) Adoption of ambitious product market reforms; (iii) Privatization of the electricity transmission network (ADMIE); (iv) A comprehensive labor market review including collective bargaining, industrial action and collective dismissals and a commitment to European best practices; (v) Large-scale privatization, including the possibility that €50 billion of assets would be turned over to an EU-controlled facility; and (vi) Broad-based administrative reform.

The best-case scenario involves comprehensive economic reform backed by agreement on a European package (ESM) by mid-August (ahead of a €3 billion payment due to the ECB on August 20th) followed by an agreement on debt relief in the fall after a first review; tranched and conditional financing from the IMF and restored access to ECB programs; a comprehensive bank restructuring and a lifting of capital control– all by the end of the year. While the timing and modalities of IMF lending have not been determined, one scenario would have the IMF program moving forward after the first ESM review, which would allow time for negotiations to begin on longer-term debt relief that the IMF insists is needed for it to agree on a program it can support.

This package could easily fail if domestic support for tough adjustment policies falters. Already, recent estimates suggest that the economy will shrink by 2-3 percent this year (versus a forecast of 0.5 percent growth previously), apparently necessitating additional adjustment measures. Given the evident risks, we need to use the leverage we have to strengthen the plan, particularly as regards debt (see below).

Lessons from the Greek Crisis

Given the exhaustive array of issues still to be negotiated, the plan that was agreed between Greece and its official creditors should be seen as a framework for a deal, not a deal itself. Yet the success or failure of the plan could be critical not only for Greece but for the future of European integration.

Any program that keeps Greece in the eurozone is going to be expensive. The agreement envisages a financing gap of €86 billion over the next three years, of which a little more than half goes to meeting debt service. The rest would allow fiscal financing, elimination of arrears, and a comprehensive fix of the banking system. But the amount is likely to grow, due to inevitable slippages and a rising bill from the recent banking system closure.

[3] http://europa.eu/rapid/press-release_IP-15-5373_en.htm

This is the price of trying to keep Greece in the eurozone, recognizing that even the strongest market-oriented reforms can cause dislocations in the short run. It is important that Europe pays its share of the financing, with an ESM program that should be close to €50 billion—not the €30-40 billion now being discussed—so that an excessive amount does not fall to the IMF or be left unfilled, undermining the program.

Already, there are some suggestions that the amount needed could be higher due to the recent, sharp economic deterioration following the closure of the banks. Further, in any economic program, and especially in this one, the risk of slippage is high. It is assumed that there will be substantial privatization revenue, and haircuts to private creditors of insolvent banks may reduce the official bailout cost. Creditors also sought to address these concerns by requiring additional budget cuts if targets are missed. But, with substantial headwinds already facing the economy, the feasibility and desirability of turning off the automatic stabilizers seem questionable.

Third, European debt remains a critical hole in our international architecture. We have a policy of private sector invovlement (PSI), and the Paris Club for developing countries. But the debt overhang in Europe has become a destabilizing force.

There is a broad consensus that Greek debt is unsustainable, a point even conceded by the German government. It may be possible to address Greece's needs in the near term through pushing out debt maturities and lowering interest rates, but a policy would be better if it came to terms more transparently with the need for debt reduction. Over the longer run a new architecture for dealing with debt is needed. I have called for a Paris Club for Europe, and now is the time to put that idea on the table. (I would like my proposal from October 2014, "A Paris Club for Europe," submitted for the record.)

The Role of the IMF

The final piece of the Greek package, financial assistance from IMF, has drawn a lot of attention following release by Fund staff of a new debt sustainability assessment showing that the proposed policies, even if fully implemented and successful, would lead to debt levels close to 200 percent of GDP and gross financing needs of over 15 percent of GDP. The IMF suggests that, for a Greek program to make sense, it needs to include nominal haircuts or very long grace periods on payment (as much as 30 years). The IMF's document has been read as suggesting the Fund will not lend if these levels of relief are not delivered. Ultimately, though, the Fund will find it extremely hard to say no when its major shareholders are so committed to the program, even if the program does not meet the Fund's internal rules (including a high probability that the debt is sustainable).

Nonetheless, the IMF is right to be concerned about both financing and debt, and of being pulled into a financing arrangement that it does not believe in. On the financing side, as noted above the setting of the gap at €86 billion, and a sequencing where the IMF program is approved after the European facilities are in place, creates a risk for the IMF, and in the absence of adequate financing and debt relief, risks making the IMF a de facto lender of last resort.

It is important to recognize that any Fund program contains risks. It will need to provide exceptional access, and if honest we need to acknowledge that even with debt relief it will not meet the test of "high probability of debt sustainability" required under IMF rules. Pragmatism and flexibility will be needed. As in 2010, a strict rules-based approach could be equivalent to forcing Greece out of the eurozone.

Overall, the Fund has acted responsibly in this phase of the crisis, correctly pressing for strong policies adequately supported by financing and debt relief. It is not going to get easier—the Fund faces a number of difficult decisions in coming months on lending and debt, and it will be vital for the U.S. to show leadership as these decisions are made. In addition, the Fund's preferred creditor status, which has been challenged by recent events in Greece, needs to be reaffirmed.

The Changing Nature of Debt Crises

Debt policy, and the IMF's role in resolving crises, has had to evolve in the face of changing markets and country conditions. Going back perhaps to the 1994 Mexico rescue package and the Korean IMF program of 1997-98, we have seen rapid growth of financial markets and greater integration in markets by large developing countries. That offers important possibilities for development and growth, but it means that when crises do occur, the financing needs are large and growing relative to resources the IMF has at hand. This is causing increasing conflict between official creditors, a conflict that is likely to intensify in coming years.

In recent years, a number of steps have been taken to address these tensions. First, there have been a number of changes to Fund rules to provide greater flexibility for it to lend beyond what its traditional quota-based rules would allow, including the exceptional access criteria in 2002 and the systemic exemption in 2010. These reforms are controversial, but I am not convinced that there are easy alternatives. The reality is that there will always be cases where events require a pragmatic policy response. No major policy maker at the time was prepared to force a debt restructuring in Greece in 2010 when the world was in the midst of a crisis (though a strong case could be made that the eventual private restructuring in 2012 came a year too late). Similarly, the 2014 Ukraine program arguably required a suspension of disbelief to argue a high probability of sustainability, but the argument was made to facilitate a loan that was clearly in the interest of official creditors including the United States.

This is not an argument for unlimited discretion, but it is a recognition that we are increasingly in an environment where the Funds rules are at odds with broader U.S. objectives. From this perspective, it is critically important that we work to modernize the IMF. And we cannot achieve this objective unless IMF quota reform is passed. Passage of this bill, by enhancing the resource base of the IMF and building stronger international support for its efforts, can reduce the number of cases where the systemic exemption would be needed.

What is at Stake for the United States

So far, the effects of this crisis on the U.S. economy have been limited. Greece is quite small as a share of U.S. trade and finance; U.S. banks have modest exposure. Also, since 2009, Europe has made important steps to address the crisis, establishing rescue facilities and strengthening buffers, and easing monetary

policies in support of growth. There has been significant financing and cash flow relief provided to Greece, including through an aggressive reduction in private debt, coupled with substantial fiscal adjustment, allowing a modest return to growth before this year's confrontation returned Greece to recession. This is not 2008, and it is not 2010.

Financial contagion occurs when financial instability in one market is transmitted into other markets[4]. The Greek debt crisis in its early stages gave rise to financial contagion, which contributed to the eurozone crisis as a whole. This can be seen in the comovement of bond yields in different markets. Figure 4 shows that since the crisis started in late 2009, the bond yield of Greece seems to exhibit comovement with those of other European countries particularly Portugal and Ireland. But that correlation appears to have broken down this year, suggesting less contagion from Greece to the rest of the eurozone.

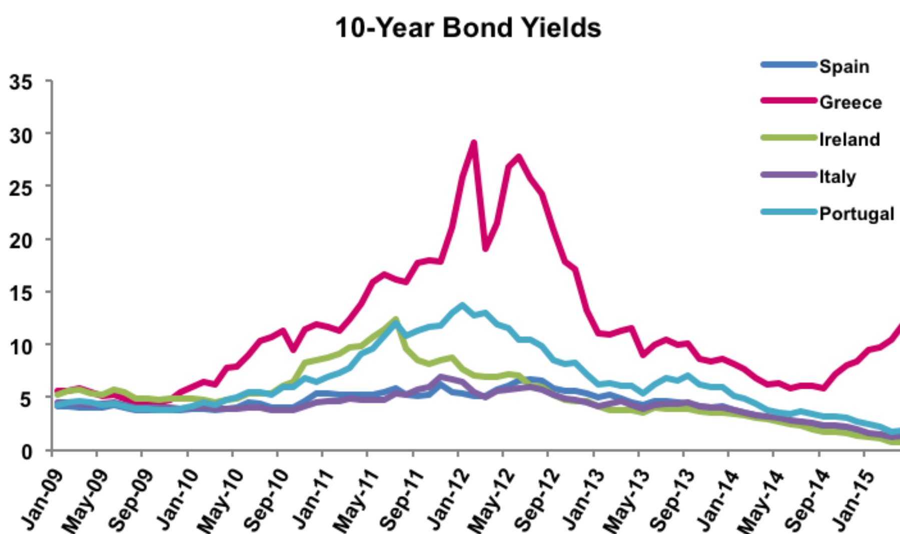
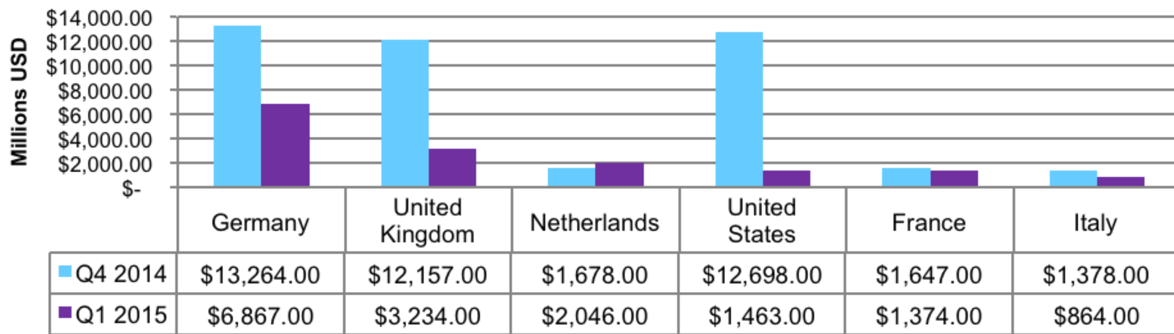


Figure 4
Source: European Central Bank (ECB)

[4] Vítor Constâncio (2012) "Contagion and the European Debt Crisis"



	Germany	United Kingdom	Netherlands	United States	France	Italy
Q4 2014	$13,264.00	$12,157.00	$1,678.00	$12,698.00	$1,647.00	$1,378.00
Q1 2015	$6,867.00	$3,234.00	$2,046.00	$1,463.00	$1,374.00	$864.00

Figure 5
Source: Bank for International Settlements

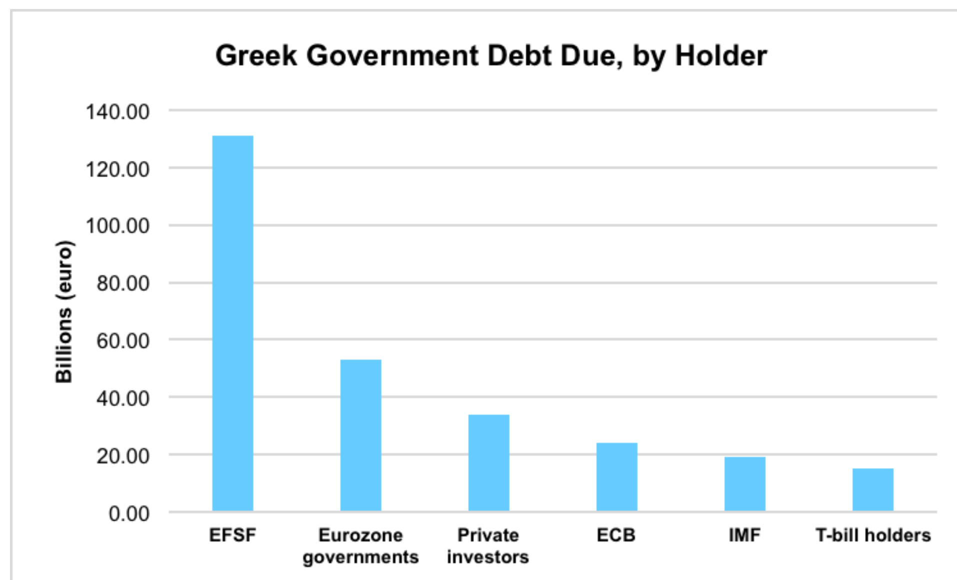


Figure 6
Source: *Wall Street Journal*

The United States, however, is not immune to a crisis in Europe. The EU is one of the largest trading partners of and shares close economic links with the United States.

Consequently, we need to be on watch for contagion—whether inside or outside the eurozone, Greece's debt is unsustainable and the recognition of losses for creditors could reveal surprising new sources of financial instability. More broadly, the crisis has revealed flaws in the architecture of Europe and, whether Greece is in or out, makes a compelling case for further economic integration. More importantly, how the crisis is handled may speak volumes for the future of Europe and the eurozone, with important economic, political, and security implications.

After Grexit, What Follows?

Should Greece decide to exit the eurozone, there is a great deal of uncertainty about what happens next. The process of introducing a proper currency could take time, though a rudimentary median of exchange could be put in place relatively quickly (perhaps through the introduction of IOUs). This would allow for an effective devaluation that would, over time, help to restore competitiveness. After Grexit, Greece would need humanitarian and technical support, an issue on which the United States could take a lead role. None of this ensures success; ultimately it is policies that determine whether Greece could thrive outside of the eurozone.

There is a broad and strongly held view among European policy analysts that Grexit, if it occurs, will be negative for the European political project and for prospects for further integration. The argument appears to be that the brinksmanship of the past month, and the divisive nature of the negotiations, has created fissures within Europe that will be difficult to mend. There is particular concern about French-German relations, and what a break means for solving a range of global problems including sanctions toward Russia, support for Ukraine, and Iran. There are also concerns that Grexit will cause a domino effect of exits elsewhere. In the United Kingdom, in particular, there are concerns that a disruptive Grexit will boost support for those that would have the U.K. leave the EU.

One could make a more positive argument, if the difficulty Greece faces causes voters in other countries to decide that confrontational or non-orthodox policies are likely to be counterproductive. In that case, Greece's problems could lead to less, rather than more support for parties such as Podemos in Spain. Either way, the most significant source of contagion from Greece may be political rather than economic.

Conclusion

The intensification of the crisis in Greece has strained European solidarity and called into question some of the fundamental assumptions of economic and monetary union. The experience has led many to call for greater integration in the union, though the terms on how to best achieve it remain divisive. As Greece attempts to move forward and put in place policies that would justify continued financial support, Europe faces a series of difficult decisions—on debt, financing and policies—that could be decisive to the outcome. The U.S. government can and should be a partner to those discussions.

In the end, we have a shared interest with our European partners in establishing a Greece—inside or outside the eurozone—that is competitive and growing. We also have a strong interest in a cohesive and economically prosperous Europe.

What happens in the coming months could go a long way to determining not only Greece's future, but also the future of European integration, and consequently Europe's relationship with the rest of the world.